No. 4048

United States Circuit Court of Appeals

For The Ninth Circuit

FIDELITY & DEPOSIT COMPANY OF MARYLAND, a corporation,

Plaintiff in Error,

vs.

JOHN P. DUKE, Supervisor of Banking of the State of Washington, liquidating the KELSO STATE BANK,

Defendant in Error.

UPON WRIT OF ERROR TO THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON, SOUTHERN DIVISION.

HON. EDWARD E. CUSHMAN, *District Judge.*

BRIEF OF PLAINTIFF IN ERROR

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THOMAS E. DAVIS,
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STATEMENT OF THE CASE.

The defendant in error recovered judgment, in the United States District Court for the Western District of Washington, Southern Division, against plaintiff in error in the amount of $25,000.00, the full penalty of the bonds hereinafter mentioned, together with interest and costs.

On April 28th, 1911, The American Bonding Co.

of Baltimore, as surety, executed a fidelity bond in the penal sum of $25,000.00 to the Kelso State Bank, of Kelso, Washington, covering one F. L. Stewart in his duties as cashier of said Bank. At the time this bond was given, the Kelso State Bank, in writing, answered certain questions propounded to it by Bonding Company, which answers it was expressly agreed should be warranties and form a part of and be conditions precedent to the issuance, continuance or any renewal of or substitution for the bond above mentioned. A copy of these questions and answers is attached to the answer of plaintiff in error as Exhibit "C" (Record, pages 60-67), and the original is in evidence as part of defendant's Exhibit 38-A.

The bond of The American Bonding Co. was continued in force by annual renewals until May 1st, 1913, at which time the plaintiff in error, having acquired The American Bonding Co., executed its bond, No. 886520, in the penal sum of $25,000.00, for a period of one year from May 1st, 1913 (Record 45-53; Exhibit 1). This bond was continued in force by annual renewal certificates until May 1st, 1920 (Exhibit 1), when bond No. 886520-A, in the penal sum of $25,000.00, effective from May 1st, 1920, was executed. (Record 54-58; 401; Exhibit 2).

Upon the execution of bond No. 886520 by the defendant in error, the Bank agreed in writing that said bond was being given upon the representations and conditions of the original statement

furnished to The American Bonding Co. (Exhibit 38-A; Record pages 70, 401, 403).

This bond expressly provides that it is executed in consideration of the statements made by the Bank relative to the cashier, his conduct, duties, employment and accounts, the manner of conducting the business of the employer and other things connected with the issuance of said bond, which statements together with any other statements in writing thereafter made by the employer to the Company relating to any such matters do and shall form a part of the contract or any continuation or continuations thereof and shall be warranties. It is further agreed that any such statements made in writing by the President, or any officer or director of the employer, shall be considered statements of the employer within the meaning of said bond. (Record 46; Exhibit 1).

During each year from 1914 to and including 1919, the Bank, in order to obtain a continuance of bond No. 886520, delivered a certificate to plaintiff in error certifying that the cashier had faithfully, honestly and punctually accounted for all money and property in his control and custody and had always proper securities and funds on hand to balance his account and was not in default to the Bank. (Record 71-78; Exhibit 38-A; Record 401, 403).

Bond No. 886520, covering the period from May 1st, 1913, to May 1st, 1920, was conditioned that the plaintiff in error would, to the extent of the

penalty thereof, reimburse the Bank for such pecuniary loss of moneys, securities or other personal property belonging to said Bank as it should sustain by any dishonest act or acts of the cashier in the performance of his duties as such cashier. (Exhibit 1; Record 45-53).

Bond No. 886520-A, covering the period from May 1st, 1920, was conditioned that the Plaintiff in error would indemnify the Kelso State Bank against loss, not exceeding the penalty thereof, of any money or other personal property through the fraud, dishonesty, forgery, theft, embezzlement or wrongful abstraction of F. L. Stewart, directly or in connivance with others, while in the service of the Kelso State Bank.

The Kelso State Bank was closed by the Banking Department on March 17th, 1921, (Record 149) the cashier disappearing on that date.

On June 9th, 1921, the defendant in error filed a claim with the plaintiff in error listing forty-nine separate transactions wherein it was claimed the Bank had suffered loss by reason of the dishonest and fraudulent acts of the cashier, aggregating the sum of $54,394.97. (Exhibit 16; Record 129-130).

On October 30th, 1921, the present action was commenced in the State Court by T. H. Adams, a Special Deputy Supervisor of Banking, to recover said sum of $54,394.97 listed in said claim and, in addition thereto, to recover the additional sum of

$3550.00 on account of certain transactions regarding which no claim had been filed. (Record 13-14; 131).

The cause was transferred to the United States District Court for the Western District of Washington, Southern Division, and, by stipulation, the present defendant in error was substituted as plaintiff. (Record 15-16).

The complaint alleged the execution of the bonds by the defendant, quoted the provisions of the bonds and alleged that, at various times during the period from 1915 to the closing of the Bank, it suffered pecuniary losses on account of dishonest and fraudulent acts of the cashier, which fraud was alleged to consist in said cashier wrongfully appropriating to his personal or individual account certain sums of money through the giving and renewal of notes, the dates and names of the makers of said notes being specifically stated. (Record 3-15).

To this complaint the plaintiff in error answered, admitting the execution of the bonds and denying the allegations relative to the fraud or dishonesty of the cashier or loss to the Bank. The plaintiff in error pleaded the statements and certificates made by the Bank as forming part of the contract, alleged breach of warranties, breach of the conditions of the bonds and failure on the part of the Bank to observe the promissory warranties contained in the statements and in the conditions of the bonds. (Record 16-36).

As an additional defense and by way of set-off,

the plaintiff in error alleged that, prior to the closing of the Kelso State Bank, said Bank, as principal, and plaintiff in error, as surety, executed to Linus Perry Brown, as County Treasurer of Cowlitz County, two certain depository bonds in the amount of $40,000.00 and $10,000.00, respectively, conditioned to guarantee deposits made by said Linus Perry Brown, as County Treasurer, in the Kelso State Bank; that, at the time said Kelso State Bank closed its doors and was taken over by the Banking Department, said Linus Perry Brown had on deposit in said Bank moneys belonging to Cowlitz County in the sum of $64,460.96, of which amount five-sevenths, or $46,163.29, was secured by said depository bonds; that plaintiff in error was obliged to pay and did pay said County Treasurer said sum of $46,163.29; and, by way of set-off, prayed that the amount owing from said Kelso State Bank to plaintiff in error, by reason of the payment of said depository bonds, be set off against any amount which defendant in error might otherwise recover on the cashier's bonds. (Record 36-39; 80-82). The allegations relative to the depository bonds were admitted in the reply (Record 84-86) and at the time of trial (Record 406), and the facts relative to the same are incorporated in the Court's finding of facts. (Record 138).

The original answer, as filed by the defendant, was amended by stipulation (Record 80-82), and the allegations in the original answer from and

after paragraph 9, on page 39 of the Record, were stricken, and in lieu thereof the allegations contained on pages 80-82 were inserted.

By stipulation a jury was waived and the case was tried to the Court. (Record 86). The Court found in favor of the defendant in error, on account of the transactions in connection with sixteen of the forty-seven items listed in the claim filed with plaintiff in error, and further found in favor of the defendant in error in connection with the Richter estate warrants, in the amount of $2,000.00, no claim for which had been made against the bond prior to the commencement of this action. (Record 129-139). All of the other claims made by defendant in error either were waived at the time of the trial or no evidence was given to support the same. (Record 130). The Court denied plaintiff in error the right of set-off by reason of having paid the County Treasurer on the depository bonds (Record 139), and entered judgment against the plaintiff in error for the sum of $25,000.00, with interest from September 9th, 1921, and costs and disbursements. (Record 144-145).

The plaintiff in error contends:

1. That it is entitled to set off, against any sum which may be due the defendant in error upon the cashier's bonds, the amount which said defendant in error owes it on the depository bonds.

2. That there was a breach of the warran-

ties and conditions contained in the cashier's bonds preventing any recovery.

3. That all of the transactions on which recovery was allowed were acquiesced in and ratified by the Kelso State Bank.

4. That the evidence does not show dishonesty or fraud on the part of the cashier.

5. That there is no evidence showing any loss to the Kelso State Bank on account of either of the transactions on which recovery was allowed.

ASSIGNMENT OF ERRORS

The plaintiff in error assigns errors as follows:

1. That the Court erred in holding that the defendant was not entitled to set off the amount which it had paid the County Treasurer of Cowlitz County upon depository bonds executed by it, as surety, and the Kelso State Bank, as principal, against its liability on the cashier's bond.

2. That the Court erred in entering judgment in favor of the plaintiff and against the defendant.

3. That the conclusion of law entered by the Court is not supported by the findings of fact and is contrary to law.

4. That the judgment entered by the Court is not supported by the findings of fact and is contrary to law.

5. That the Court erred in permitting the

witness Adams to testify in substance that, when two notes executed by H. D. Phillips, in the amount of Fifteen Hundred Dollars ($1500.00) each, entered the Kelso State Bank on March 20, 1918, a cash item initiated on March 11, 1918, in the amount of Thirty-two Hundred Dollars ($3200.00) disappeared; and in permitting said witness Adams to testify that, when said cash item originated on March 11, 1918, the savings account of F. L. Stewart, Guardian of Henry Dearing, an incompetent, was credited with the sum of Three Thousand Dollars ($3,000.00).

6. That the Court erred in permitting the witness Adams to testify in substance that, on March 1, 1921, the individual account of F. L. Stewart received a credit of Four Hundred Fifty Dollars ($450.00) and that a cash item of Twelve Hundred Fifty Dollars ($1250.00) disappeared from the records of the Bank on March 10, 1921, when a note of the Northwest Transportation Company for (379) Twelve Hundred Fifty Dollars ($1250.00) entered the Bank.

7. That the Court erred in permitting the witness Adams to testify in substance that, on March 10, 1921, when a note of the Northwest Transportation Company in the amount of Twelve Hundred Fifty Dollars ($1250.00) entered the Kelso State Bank, a cash item in the sum of Twelve Hundred Fifty

Dollars ($1250.00) disappeared from the records; and that said cash item of Twelve Hundred Fifty Dollars ($1250.00) originated in the record on the first of March, 1921, on which date, under individual deposits, F. L. Stewart received credit for Four Hundred Fifty Dollars ($450.00) and the Kelso Farm Company received credit for Eight Hundred Dollars ($800.00).

8. That the Court erred in permitting the witness Adams to testify in substance that, on October 23, 1920, four warrants in the amount of Five Hundred Dollars ($500.00) each, belonging to the estate of Phillip Richter, deceased, of which estate F. L. Stewart was administrator, were placed in the assets of the bank by F. L. Stewart and that said F. L. Stewart took credit to his account for the sum of Two Thousand Dollars ($2,000.00) and that later said Kelso State Bank surrendered said warrants to the estate of Phillip Richter, deceased.

9. That the Court erred in allowing any recovery on account of notes executed by Frank Shepard.

10. That the Court erred in allowing any recovery on the notes executed by the Northwest Transportation Co.

11. That the Court erred in allowing any recovery on the note executed by Fritz Kruze.

12. That the Court erred in allowing any recovery on the note of T. P. Fisk.

13. That the Court erred in allowing any recovery on the notes of H. D. Phillips.

14. That the Court erred in allowing any recovery on the notes of the Kelso Farm Co.

15. That the Court erred in allowing any recovery on the Richter estate warrants.

16. That the Court erred in making finding of fact No. IV.

17. That the Court erred in making finding of fact No. V.

18. That the Court erred in making finding of fact No. IX.

19. That the Court erred in making finding of fact No. XI.

20. That the Court erred in making finding of fact No. XIII.

21. That the Court erred in making finding of fact No. XIV.

22. That the Court erred in making finding of fact No. XVI.

23. That the Court erred in making finding of fact No. XVIII.

24. That the Court erred in making finding of fact No. XIX.

25. That the Court erred in its conclusion of law.

26. That the Court erred in refusing to adopt defendant's proposed finding of fact No. IV.

27. That the Court erred in refusing to

adopt defendant's proposed finding of fact No. VIII.

28. That the Court erred in refusing to adopt defendant's proposed finding of fact No. IX.

29. That the Court erred in refusing to adopt defendant's proposed finding of fact No. XI.

30. That the Court erred in refusing to adopt that portion of defendant's finding of fact No. XIV reading as follows:

> "That the assistant cashier and other officers of the bank knew of said notes and knew that the Northwest Transportation Co. was borrowing from said Kelso State Bank, and ratified said loans."

31. That the Court erred in refusing to adopt defendant's proposed finding of fact No. XV.

32. That the Court erred in refusing to adopt defendant's proposed finding of fact No. XVI.

33. That the Court erred in refusing to adopt defendant's proposed finding of fact No. XVII.

34. That the Court erred in refusing to adopt that portion of defendant's proposed finding of fact No. XVIII, reading as follows:

> "That the notes executed by said Phillips were secured by a mortgage on said farm purchased by Phillips from Stewart."

35. That the Court erred in refusing to adopt that portion of defendant's proposed finding of fact No. XIX reading as follows:

> "That, on January 11, 1921, the board of directors of the Kelso State Bank authorized a loan to F. L. Stewart in the amount of Six Thousand and No/100 ($6,000.00) Dollars, and there was no loan made to him or note of his placed in said Bank after said date, except said two notes of the Kelso Farm Co."

36. That the Court erred in refusing to adopt defendant's proposed finding of fact No. XX.

37. That the Court erred in refusing to adopt defendant's proposed finding of fact No. XXI.

38. That the Court erred in refusing to adopt defendant's proposed finding of fact No. XXII.

39. That the Court erred in refusing to adopt defendant's proposed finding of fact No. XXIII.

40. That the Court erred in refusing to adopt defendant's proposed finding of fact No. XXV.

41. That the Court erred in refusing to adopt defendant's proposed conclusion of law No. I.

42. That the Court erred in refusing to adopt defendant's proposed conclusion of law No. II.

ARGUMENT

The Court Erred in Denying the Right of Set Off.

It is stipulated that, at the time the Kelso State Bank closed, the County Treasurer of Cowlitz County, Washington, had on deposit in said Bank the sum of $64,460.96, of which sum $46,-163.29 was secured by depository bonds theretofore executed by the Kelso State Bank, as principal, and the plaintiff in error, as surety; that the plaintiff in error was obliged to and did pay the County Treasurer the sum of $46,163.29, and that no part of this sum has been paid, except dividends amounting to 20 per cent, leaving a balance of $36,930.63 owing from the defendant in error to plaintiff in error. (R. 406; 36-39; 80-82; 138).

The plaintiff in error is entitled to set-off, against any sum which might be due defendant in error on the cashier's bond, the amount which said defendant in error owes it on the depository bonds.

The Statutes of the State of Washington relative to counter-claims and set-off are as follows:

> "Sec. 265. The counter claim mentioned in the preceding section must be one existing in favor of a defendant, and against a plaintiff between whom a several judgment might be had in the action, and arising out of one of the following causes of action:
>
> 1. A cause of action arising out of the contract, or transaction set forth in the com-

plaint, as the foundation of the plaintiff's claim, or connected with the subject of the action;

2. *In an action arising on contract, any other cause of action arising also on contract, and existing at the commencement of the action.*"

"Sec. 266. The defendant in a civil action upon a contract expressed or implied, may set off any demand of a like nature against the plaintiff in interest, which existed and belonged to him at the time of the commencement of the suit. *And in all such actions*, other than upon a negotiable promissory note or bill of exchange, negotiated in good faith and without notice before due, *which has been assigned to the plaintiff, he may also set off a demand of a like nature existing against the person to whom he was originally liable*, or any assignee prior to the plaintiff, of such contract, *provided such demand existed at the time of the assignment thereof, and belonging to the defendant in good faith, before notice of such assignment and was such a demand as might have been set off against such person to whom he was originally liable*, or such assignee while the contract belonged to him."

"Sec. 267. If the plaintiff be a trustee to any other, or if the action be in a name of the plaintiff who has no real interest in the contract upon which the action is founded, so

much of a demand existing against those whom the plaintiff represents or for whose benefit the action is brought, may be set off as will satisfy the plaintiff's debt, if the same might have been set off in an action brought by those beneficially interested."

"Sec. 268. In actions brought by executors and administrators, demands against their testators and intestates, and belonging to defendant at the time of their death, may be set off by the defendant in the same manner as if the action had been brought by and in the name of the deceased."

"Sec. 271½. If the amount of the set off, duly established, be equal to the plaintiff's debt or demand, judgment shall be rendered that the plaintiff take nothing by his action; if it be less than the plaintiff's debt or demand, the plaintiff shall have judgment for the residue only."

Remington's Compiled Statutes of the State of Washington, 1922.

In its opinion, the trial court said:

"The claim of set-off in the instant case is based upon the assigned claims of the County Treasurer to the defendant, made after the closing of the Bank." (R. 97).

In neither the pleadings nor in the argument in the lower court did plaintiff in error base its claim of set-off on assignments made to it after the Bank closed. In its answer, plaintiff in error, after plead-

ing the facts relative to the depository bonds, the closing of the Bank, the amount of County money on deposit at the time the Bank closed, the payment in full of this amount by the two surety companies, of which amount plaintiff in error was obliged to pay and did pay the sum of Forty-six Thousand One Hundred Sixty-three and 29/100 ($46,163.29) Dollars, specifically alleged:

> "That, upon paying said sum to said Linus Perry Brown, as aforesaid, on account of said bonds, said defendant became subrogated to all claims, demands, actions and causes of action which said Linus Perry Brown, as County Treasurer, or said Cowlitz County, the owner of said funds, had against said Kelso State Bank by reason of having said money on deposit in said Bank, as aforesaid; that the right of subrogation related back to the time when this defendant executed said bonds to said Linus Perry Brown, and related back to a time prior to the time when the Kelso State Bank closed its doors and was taken over by said Claude P. Hay, then Bank Commissioner of the State of Washington." (R. 38).

In the oral argument and in the written briefs in the trial Court, plaintiff in error based its claim of set-off on its right as a surety, having paid an obligation of its principal on a bond executed prior to the closing of the Bank.

The trial Court apparently failed to distinguish between the right of a surety upon paying an obli-

gation for its principal and the right of a volunteer purchasing a claim after the closing of the Bank.

The Bank being insolvent, equity will, regardless of statute, protect the surety to the extent that it will not permit a recovery to be had on the obligation which the surety owes the Bank until the Bank has fully indemnified the surety for the moneys which it has been obliged to pay on account of the suretyship.

Kilby v. First National Bank, 66 N. Y. S. 579;

Blumenthal v. Einstein, 30 N. Y. S. 1126;

32 Cyc. 246;

2 Michie on Banks & Banking, 1073;

21 R. C. L. 1123;

Dudley Lumber Co. v. Nolan Bros. Lumber Co. (Tenn.) 46 L. R. A. (N. S.) 62, and cases cited in notes;

Funk v. Young (Ark.), 5 A. L. R. 79;

Griffin v. Long (Ark.), 131 S. W. 672;

In re Stout, 109 Fed. 794;

In re Dillon, 100 Fed. 627.

Mervin v. Austin (Conn.), 18 Atl. 1029; 7 L. R. A. 84.

This case is entirely distinguishable from cases holding that the debtor of an insolvent bank cannot set off a claim assigned to him after its insolvency. In the instant case, defendant's rights related back to the execution of the bonds, and the defendant, in paying the County Treasurer, was not a volunteer attempting to secure a set-off against the Bank,

but was paying a liability which became fixed when the Bank suspended.

The case of *Kilby v. First National Bank*, 66 N. Y. S. 579, expressly holds that the surety's position is entirely different from that of a debtor who, owing the bank, goes upon the street after the bank's suspension and buys up a claim to which he had no previous relation with the express purpose of using it as an off-set, the Court saying:

> "The defendant bank, at the moment when it suspended, owed three accounts which, in this action, are to be deemed then due and payable. It was insolvent and could not pay them, and plaintiff, by express agreement and otherwise, was individually liable to make good every dollar of every deposit. He has the right to treat his responsibility as then accrued and fixed, and could have pursued the Bank for the total amount of all the deposits. *Clute v. Warner*, 8 App. Div. 40, 40 N. Y. S. 392. As a matter of fact, some time was taken to adjust his liability with the parties to whom he was bound to make good the deposits, and to fix and liquidate his individual responsibility in the case of two of them. This, however, was all done in pursuance to and in recognition of a liability which existed at the date of suspension; and, for the purpose of this action, the payments will be deemed to relate back, and to have been made as of that date. *Rice v. Southgate*, 16 Gray, 142. So that, in con-

clusion, we have plaintiff, as of the date when the bank suspended, becoming liable for the amount of three deposits which he was bound to make good when the bank defaulted, and in liquidation of that liability paying the sum of $3,785.55, which he asks to have off-set on what the bank or its receiver holds against him. It seems to me that he is entitled to this relief; that whether it be regarded that, as a surety for the bank, he has paid up in part these deposits and become subrogated to the rights and claims of those to whom they belonged, or simply that, by the failure and default of the bank, he became liable for a certain amount, which he has liquidated and paid, in either event equity will give him credit upon his indebtedness for his payment thus made. *Blumenthal v. Einstein*, 81 Hun. 415, 30 N. Y. Supp. 1126."

In *Blumenthal v. Einstein*, 30 N. Y. Supp. 1126, cited in the foregoing quotation, the court said:

"In equity a solvent surety is protected from the claims of his insolvent creditor. For example, in case A., who is solvent, owes B., who is insolvent, one hundred dollars, and A. is surety for B. in the sum of two hundred dollars, equity will restrain B. from collecting the one hundred dollars and will compel its application on the debt for which A. is surety."

The rule stated in Cyc. is as follows:

"If, however, the principal or his estate, is

insolvent, equity recognizes the right of the surety to retain any funds of the principal in his hands, even as against an assignee of the principal; and the principal will not be allowed to recover from his surety without first indemnifying the latter."

32 Cyc. 246.

In *Barrett's case*, 46 English Reprint, 1116, cited in foot-note to 32 Cyc. 246, it was held that, while ordinarily the debtor of a bankrupt's estate or an estate being wound up cannot buy up counter claims subsequent to the bankruptcy or the winding-up order for the purpose of making a set-off, it is otherwise where there is an actual ownership of a counter-claim arising in consequence of some anterior matter.

In Michie on Banking, the rule is stated as follows:

"Where a party executes a guaranty for the payment of sums deposited in a bank to which he is indebted, which sums are due and payable at the time of the bank's suspension, equity will give him credit on his indebtedness for the payments made because of the bank's failure to do so, whether he is regarded as a surety, and becomes subrogated to the rights and claims of the depositors, or simply that by the bank's failure and default he becomes liable for such sums."

2 Michie on Banks & Banking, 1073.

"A sole solvent surety for a hopelessly in-

solvent principal, on indebtedness due before the appointment of a trustee in insolvency, is entitled to set-off his claim for the payment of his debt against the debt due from him to the insolvent, in a suit on them brought by the trustee, although the insolvency was not known when the debt became due and payment by the surety was not actually made until after the trustee was appointed.

"* * * When the holder of a claim not yet due, arising upon contract, becomes insolvent, and transfers the same before maturity, and the debtor at the time of the transfer holds a similar claim, then due, against the assignor, his right of set-off is preserved against the assignee when the latter's cause of action arises; and a surety on the obligation so transferred may enforce the set-off for his own protection if the principal debtor be insolvent."

21 R. C. L. 1123.

See also:

24 R. C. L. 861, 862 and cases cited;

Stealman v. Atchley (Ark.), 135 S. W. 902; 32 L. R. A. (N. S.) 1060;

Dudley Lumber Co. v. Nolan Bros. Lumber Co., (Tenn.) 156 S. W. 465; 46 L. R. A. (N. S.) 62;

Fishbourne v. Merchants Bank of Port Townsend, 42 Wash. 473; 85 Pac. 38;

Merwin v. Austin, (Conn.) 18 Atl. 1029; 7 L. R. A. 84;

Puget Sound State Bank v. Washington Paving Co., 94 Wash. 504; 162 Pac. 870;

Scott v. Armstrong, 146 U. S. 499; 36 L. Ed. 1059;

16 Rose's Notes, 191;

Williams v. Johnson, (Mont.) Ann. Cas. 1916 D. 595; 144 Pac. 768;

Philler v. Yardley, 62 Fed. Rep. 645;

Re Hatch, 40 L. R. A. 664; 155 N. Y. 401;

Merrill v. Cape Ann Granite Co., Mass. 23; L. R. A. 313.

The surety, having paid since the Bank became insolvent, its right of subrogation against its principal relates back to the date of the giving of the bonds which compelled it to make payment to the County Treasurer.

25 R. C. L. 1328;

Hardaway v. National Surety Co., 211 U. S. 561; 53 L. Ed. 321, 327;

Prairie State Bank v. U. S., 164 U. S. 227; 41 L. Ed. 413;

Henningsen v. U. S. F. & G. Co., 143 Fed. 810, 814 (C. C. A. 9th Circuit); 208 U. S. 404; 52 L. Ed. 547;

First National Bank v. City Trust, Safe Deposit & Surety Co., 114 Fed. 529 (C. C. A. 9th Circuit);

Wasco County v. New England Equitable Insurance Co. (Ore.) L. R. A. 1918 D 732; 172 Pac. 126;

Maryland Casualty Co. v. Washington National Bank, 92 Wash. 497;

In re Scofield Co., 215 Fed. 45, 50;

Re P. McGarvy & Son, 240 Fed. 400, 402;

Derby v. U. S. F. & G. Co. (Ore.) 169 Pac. 500.

The right of set-off in favor of sureties is applied as against receivers or assignees of insolvent banks.

Mercer v. Dyer, 15 Mont. 317; 39 Pac. 314;

Funk v. Young (Ark.) 5 A. L. R. 79;

U. S. F. & G. Co. v. Maxwell (Ark.), 237 S. W. 708.

We particularly call the court's attention to the case of *United States Fidelity & Guaranty Company v. Maxwell*, above cited. The authorities are collected in this case both in the majority and in the dissenting opinions. The majority of court denied the right of set-off in that case for the reason that there was no privity between the bank and the surety, the bank not being a party to the insurance policy and there being no relationship of principal and surety. In that case the deposit was covered by an insurance policy to which the bank was not a party, while in the instant case, the bank was the principal on the bond to the County Treasurer and the plaintiff in error was surety.

A surety is to be deemed a creditor of his principal from the time when he enters into the con-

tract of suretyship, and not from the time when he pays the debt of the principal.

Griffin v. Long (Ark.), 131 S. W. 672; Ann. Cas. 1912 B. 622 and note; 35 L. R. A. (N. S.) 855;

Danforth v. Robinson (M. E.), 15 Atl. 27; 6 A. S. R. 224;

Kahn v. Bledsoe (Okla.), 98 Pac. 921; 132 A. S. R. 665;

U. S. F. & G. Co. v. Ryan, 24 Wash. Dec. 258; 214 Pac. 433.

For the purpose of fixing the date when the indebtedness of the principal to him, on account of the payment of a note, had its inception, the payment of the note by the surety relates back to the signing of the note.

In re Stout, 109 Fed. 794.

> "In an action by an assignee, under a general assignment, upon a debt due his assignor, the defendant can set-off his liability as surety upon bonds of the assignor as guardian and trustee, in which capacity he had converted a portion of the estate thereof to his own use prior to the assignment, for some of which defendant has been compelled, as such surety, to pay and as to the balance of which actions are pending."

Morrisen v. Noyes, (Wis.) 81 N. W. 860.

A surety, who pays the debts of his bankrupt principal after the adjudication in bankruptcy,

may set-off the amount so paid against his debt to the bankrupt.

In re Dillon, 100 Fed. 627;

Morgan v. Wordell, 55 L. R. A. 33; Mass. 350.

Under the provisions of Section 267, Remington's Compiled Statutes of Washington, 1922, and also in Equity, the set-off should have been allowed.

In the case of *United States Fidelity & Guaranty Co. v. Ryan*, 24 Wash. Dec. 258; 214 Pac. 433, the supreme court of the State of Washington held that the surety is to be deemed a creditor of its principal, at the latest, from the time of the default of the principal. In the lower court in the present case, some contention was made by the defendant in error that the plaintiff in error was not entitled to a set-off in the present action, because plaintiff could not plead an equitable set-off in an action at law. Whether the set-off is legal or equitable is immaterial since the Act of March 3rd, 1915, Section 274 (b), which expressly provides that, in all actions at law, equitable defenses may be interposed by answer, plea or replication, without the necessity of filing a bill on the equity side of the Court. (38 Stat. L. 956).

In the trial court, defendant in error argued that the present action is for damages and sounds in tort. The only cases cited in support of this theory were certain cases arising under the statute of limitations, wherein the courts held that an action could not be brought on a bond after the

statute of limitations had run against the principal obligation. These cases merely held that, since a bond is in the nature of collateral security for the performance of an obligation by the principal, the discharge of the principal obligation bars an action on the collateral security contract. The same rule is applied in actions to foreclose mortgages after the principal debt has been barred by the statute of limitations.

Pratt v. Pratt, 121 Wash .....; 21 Wash. Dec. 177; 209 Pac. 535.

This is entirely different from holding that a mortgage or a bond is not a contract, or that an action thereon is not *ex-contractu*. In order to recover on the bond or foreclose the mortgage, it is necessary, in the same suit or in an independent suit, to prove a valid obligation against the principal or on the principal debt. If such an obligation is established, the right to recover on the bond or to foreclose the mortgage exists *because of the contract contained in the bond or in the mortgage*, for, without such contract, there would be no collateral security.

Plaintiff's contention would make defendant a joint tort-feaser. The complaint in this action is based upon the contracts contained in the bonds, executed by the plaintiff in error. It is apparent that plaintiff in error has not committed any tort and that the only claim that the defendant in error can have against plaintiff in error is by virtue of the contracts contained in the bonds.

Edward F. Gerber v. Title Guaranty & Surety Co., 216 Fed. 980;

4 Joyce on Insurance (2nd Ed.) 4672, 4673.

An action on a bond is an action *ex-contractu*, even though the breach arose in the commission of a tort.

State v. Lichtman (Mo.), 168 S. W. 367;
State v. United States Fidelity & Guaranty Co. (Mo.), 115 S. W. 1081;
Leader v. Mattingly (Ala.), 37 So. 270;
Mumford v. Soloman (Ga.), 68 S. E. 1075;
Moore v. State (Ind.), 16 N. E. 836;
Ranger v. Boswinkle (Ind.), 96 N. E. 208;
Midland Co. v. Broat (Minn.), 52 N. W. 972.

See also:

Puget Sound State Bank v. Gallucci, 82 Wash. 445; 144 Pac. 698.

In the case of *State v. Lichtman* (Mo.), 168 S. W. 367, *supra*, the court said:

> "This is an action for damages on a judgment bond and, while it requires the commission of a tort to constitute a breach of a contract, nevertheless it is an action *ex-contractu* and not *ex-delicto*, and conceding that plaintiff was entitled to recover, our courts have decided that defendants would have a right to set-off whatever is due them from relator * * *"

The claim of the plaintiff in error against the defendant in error, by reason of having paid the

depository bond, is likewise an action arising out of a contract and, under the provisions of Section 265 of Remington's Compiled Statutes of Washington, 1922, constitutes a valid set-off or counter claim.

To deny the right of set-off in the instant case is to announce a doctrine contrary to the decisions of the United States supreme court, of the state courts and of the federal courts, holding that the surety's right, upon payment of its obligation, relates back to the time of the signing of the bond. The denial of such right is also contrary to the well established rule of law that the right of set-off is available to a solvent surety for an insolvent principal in an action by a receiver, an assignee for the benefit of creditors, or a trustee in bankruptcy. It is respectfully submitted that the trial court erred in denying the right of set-off and in refusing to adopt defendant's proposed conclusion of law No. 2. (R. 126).

The Court Erred in Allowing Any Recovery.

Items on which Recovery was allowed.

The court allowed recovery on account of the following transactions:

NOTES OF H. D. PHILLIPS

Date	Amt. of Note.	Amt. of Recovery
March 20, 1918....	$1500.00	$1500.00
March 20, 1918....	1500.00	1500.00
March 20, 1918....	550.00	550.00
April 11, 1918....	500.00	500.00

NOTES OF FRANK SHEPARD

April 23, 1920	$1000.00	
July 19, 1920	1000.00	
August 13, 1920	1000.00	
August 13, 1920	1000.00	
		$3200.00

NOTES OF NORTHWEST TRANSPORTATION COMPANY

April 3, 1920	$2500.00	$2500.00
Sept. 1, 1920	5000.00	2104.78
March 10, 1921	1250.00	1250.00

NOTE OF FRITZ KRUSE

Sept. 10, 1920	$5000.00	$4880.00

NOTE OF T. P. FISK

January 19, 1921	$6250.00	$5000.00

NOTES OF KELSO FARM COMPANY

January 12, 1921	$2200.00	$2200.00
February 15, 1921	3750.00	3750.00

RICHTER ESTATE WARRANTS

November, 1921	$2000.00	$2000.00

We will consider these transactions in the above order:

Phillips Notes

The claim filed with the plaintiff in error (Ex. 16) shows that Phillips notes, upon which claim is based, entered the Bank on March 20, 1918, April 11, 1918, and April 5, 1919.

The first two items in connection with the Phillips transactions are two notes of $1500.00 each which

passed into the Bank March 20, 1918. It is alleged in the complaint and in the claim filed that the entire proceeds of these notes were misappropriated by F. L. Stewart. (R. 9-10; Ex. 16). The testimony shows that, when these notes were discounted in the Kelso State Bank, none of the proceeds passed to the credit of F. L. Stewart, but a cash item of some $3200.00 which was initiated on March 11, 1918, disappeared. It further appears that this cash item had something to do with the estate of Henry Deering and the cannery mortgage. (R. 156-157).

No claim was made or action brought on account of the Dearing estate or the cannery mortgage, and evidence relative thereto was irrelevant, as not pleaded.

State v. Larson, 119 Wash. 259; 205 Pac. 373.

When these two $1500.00 notes of March 20, 1918, which took up the cash item, entered the Bank, the Bank lost nothing, but it appears that Mr. Stewart was voluntarily protecting the Bank by these two notes on account of some transaction or transactions coming down into the $3200.00 cash item, as to which no claim was propounded or suit brought. If the Bank lost anything, it was when the cash item originated, but plaintiff in error was not sued upon that item or advised thereof prior to trial.

There was certainly no loss to the Bank or any gain to Stewart when these notes were placed in the

Bank, because the Bank parted with nothing of value and Stewart received nothing of value.

The court allowed full recovery on the note of $550.00 executed by H. D. Phillips on March 20, 1918. When this note entered the Bank, the sum of $50.00 was credited to the account of F. L. Stewart. (R. 157-158; Finding of Fact No. 17; R. 137).

The next Phillips item appears to have entered the Bank on April 11, 1918, when a note for $1500.00 executed by Phillips entered the Bank which renewed a prior note to the same party for $1000.00 and that $500.00 was deposited to the account of F. L. Stewart. (R. 158-159).

In paragraph 16 of its findings, the court found that the Bank suffered a loss of Four Thousand Fifty and No/100 ($4050.00) Dollars through notes given by Phillips. (R. 136). In paragraph 17, relative to the $550.00 note, above mentioned, the court finds that Fifty and No/100 ($50.00) Dollars of this amount was credited to the account of F. L. Stewart (R. 137), and no finding is made relative to the disposition of the other Five Hundred and No/100 ($500.00) Dollars. However, the evidence is that only Fifty and No/100 ($50.00) Dollars was deposited to the credit of Stewart. (R. 157-158). From finding 17 and from the evidence, it therefore seems that the court erroneously allowed recovery in the amount of $4050 on the Phillips notes, although intending to allow recovery

for Thirty-five Hundred Fifty and No/100 ($3550.00) Dollars only.

It appears from the testimony of Mr. Adams (R. 221), the testimony of Mr. Fletcher (R. 288-291) and from the abstract of title (Ex. 24) that all of the Phillips notes were given to Mr. Stewart in part payment of the purchase price of a farm which Phillips bought from Stewart. There is no evidence that the cashier did not consider the notes good or that he was guilty of bad faith in discounting them. Phillips was satisfied with his bargain and renewed the notes from time to time. The Bank took renewals of the notes (R. 204-207), accepted interest on the same, discounted the notes with other Banks, and discounted the renewals with other Banks. A reference to the notes which were introduced in evidence (Ex. 7) will show that the renewal notes now in the possession of the Bank, have been discounted with other Banks. There is no evidence that the proceeds of the Phillips notes were ever withdrawn by Mr. Stewart, or any one else, from the Bank, and, therefore, no evidence of loss.

Frank Shepard Notes

In the claim filed with the plaintiff in error and in the complaint, defendant in error alleged that the Bank suffered loss on account of the Shepard notes, as of the dates said notes entered the Bank, namely: April 23, 1920; July 19, 1920; August 13, 1920. The undisputed evidence showed that, prior to March 5, 1920, Frank Shepard had purchased a

one-half interest in the Northwest Transportation Company from Mr. Stewart for the sum of Fifteen Thousand and No/100 ($15000.00) Dollars, giving his notes for Fourteen Thousand and No/100 ($14000.00) Dollars, payable to the Kelso State Bank, and paying One Thousand and No/100 ($1000.00) Dollars in cash. These notes were fourteen (14) in number, in the principal sum of One Thousand and No/100 ($1000.00) Dollars each, and entered the Bank on March 5, 1920. (R. 358; Ex. 16) Mr. Stewart received nothing from the proceeds of these notes, the Bank paid nothing for them, and they were used by the Bank in retiring other paper held by the Bank. In acquiring these notes the Bank parted with nothing. (Deft's. Ex. 16). Six of these notes, amounting to Six Thousand and No/100 ($6000.00) Dollars, were discounted with the United States National Bank of Portland, the Kelso State Bank receiving the proceeds. (R. 360). No claim was filed or complaint made on account of the transactions involving these notes of March 5, 1920. As four of the notes which had been discounted with the United States National Bank of Portland became due, they were not paid by the maker, and Mr. Stewart paid them, each time sending his personal check for $1000.00 to Frank Shepard in Portland, with instructions to Shepard to pay the note then due and held by the United States National Bank. (R. 360-361). Mr. Shepard, pursuant to instructions, upon receiving each check, took it to the United

States National Bank and paid that Bank the amount of the note then due and interest, paying the interest himself. After each of these payments had been made, Mr. Shepard executed a new note in the amount of One Thousand and No/100 ($1000.00) Dollars to the Kelso State Bank and, when said new note passed into the Bank, the proceeds thereof were deposited to the credit of Mr. Stewart in the Kelso State Bank, thereby reimbursing him for the amount which he had paid the United States National Bank. (R. 364-365; 132-133). It was on account of these new notes that claim was made and recovery allowed.

Instead of having the Kelso Bank pay its obligations as indorser on the notes discounted to the Portland Bank, the cashier personally paid the same, thereby advancing for the use of the Kelso Bank the amount necessary to pay the notes. When the new notes, executed by the maker of the original notes, entered the Kelso Bank and the proceeds were deposited to the account of Stewart, the Kelso Bank did not pay out anything that it was not, on account of previous transactions, bound to pay, and it was in exactly the same position as if the United States National Bank had returned the original notes and charged the Kelso Bank's account with the same.

Furthermore, these four (4) notes, on which recovery was allowed, were renewed at various times (R. 195-196); interest was paid and accepted on them; they were kept in their proper files in the

Bank; their existence was shown on the books of the Bank; the transactions relating to their entry into the Bank and the credit of their proceeds to the account of the cashier was clearly made of record on the books of the Bank; the officers of the Bank knew of their existence; and the defendant in error, after he had taken possession of the Bank, dealt with them as the property of the Bank, settled with the maker by accepting twenty cents on the dollar, and surrendered the notes to the maker as fully paid. (R. 193-194). This settlement and surrender of the notes was made in spite of the fact that the uncontradicted testimony of the maker of the notes is that, at the time the notes were given, he was worth from Sixty to Sixty-five Thousand Dollars (R. 376), and there is no evidence that he was in a worse condition financially at the time settlement was made than when the notes were executed.

When the original fourteen (14) notes, amounting to Fourteen Thousand and No/100 ($14000.00) Dollars, came into the Bank, it paid out nothing and, therefore, sustained no loss at that time. When the notes in question came into the Bank and the proceeds were credited to the cashier to reimburse him on payments made by him on the Bank's rediscounted paper, the Bank paid out nothing that it was not legally obligated to pay whether these notes were received or not.

It is submitted that the court erred in allowing any recovery on account of these notes. Further-

more, there is no evidence that Mr. Stewart ever drew out the amount with which his account in the Bank was credited at the time these notes entered the Bank; nor is there any evidence as to what amount his account was credited with at the time the Bank closed. From all that the record shows, it will only require a bookkeeping transaction, if Mr. Stewart was not entitled to this credit, to restore the *status quo* existing prior to April 23, 1920.

Northwest Transportation Company Notes

The Northwest Transportation Company notes, upon which recovery was allowed, are as follows:

Note of April 3, 1920, for $2500.00.

Note of September 1, 1920, for $5000.00 on which recovery was allowed of $2104.78.

Note of March 10, 1921, for $1250.00 on which recovery was allowed in the amounts of $800.00 and $450.00, respectively.

The testimony showed that Mr. Stewart was a stockholder in the Northwest Transportation Company. He personally loaned this company the sum of Twenty-five Hundred and No/100 ($2500.00) Dollars which was used by the company in purchasing a certain steamboat, known as the "Kellogg." The $2500.00 note of April 3, 1920, was given by the Northwest Transportation Company to Mr. Stewart as evidence of said company's indebtedness to him on account of this loan. When this note entered the Bank, Mr. Stewart's account was credited with the sum of Twenty-five Hundred

and No/100 ($2500.00) Dollars. (R. 367, 134).

The note of $5000.00, out of which recovery was allowed in the sum of Twenty-one Hundred Four and 78/100 ($2104.78) Dollars, entered the Bank September 1, 1920. Mr. Stewart had advanced his own money to pay bills for the Northwest Transportation Company (Ex. 25-A), which advance amounted to more than the credit taken out of this note. (R. 134). The testimony of Mr. Shepard and the letters in evidence (Ex. 25-A) show that the sum of Twenty-one Hundred Four and 78/100 ($2104.78) Dollars was deposited to the credit of Mr. Stewart in partial reimbursement to him for moneys which he had advanced to pay debts of the Northwest Transportation Company.

The $1250.00 note of March 10th was executed by the Northwest Transportation Company to reimburse Mr. Stewart for moneys which he had previously deposited in the Kelso Bank to the credit of said Company. (R. 135). The testimony relative to this note is that the proceeds were not deposited to Mr. Stewart's account, but were used to take up a cash item in the sum of Twelve Hundred Fifty and No/100 ($1250.00) Dollars which had previously originated. (R. 171-172). There was no claim made in the complaint on account of any loss in connection with this cash item, and, as the Bank parted with nothing when the $1250.00 note came into the Bank, the Bank did not suffer any loss. All evidence pertaining to the cash item went in over defendant's objection and motion to

strike and was not within the issues of the case. (R. 170-173).

In the claim filed with plaintiff in error (Ex. 16), and in the complaint (R. 12), the only amount claimed on account of the $1250.00 note, last above mentioned, was $800.00. There was a claim made for the sum of $450.00 out of a note of $2000.00, dated January 19, 1921. (R. 12). Over plaintiff's objections and motions to strike, the court permitted the defendant in error to introduce testimony, showing that the $450.00 was in connection with the $1250.00 note of March 10th, instead of the $2000.00 note of January 19th. (R. 212-213).

All of the Northwest Transportation Company notes, except the $1250.00 note of March 10th, were renewed from time to time by the Bank. The Bank held a mortgage on the Steamer "Olympian" as security for these notes (R. 266), and defendant in error ratified the transactions by foreclosing the loan, receiving and retaining the proceeds of the sale and not accounting therefor either in his claim or in his complaint. (R. 384).

Fritz Kruse Notes

Plaintiff's notice of claim and action is upon a note of September 10, 1920, in the sum of $5000.00 of which the notice and complaint charge that Stewart appropriated $4880.00. Mr. Kruse, as a witness for defendant in error, testified that this note was paid and returned to him (R. 284) and that, about three months later, he gave Stewart two notes of $2500.00 each (R. 284), which are the

notes in the possession of plaintiff. (Pltf's. Ex. 4).

Under the testimony, these notes are shown not to be renewal of the note sued on, which was paid, and no claim or suit has been propounded or brought on the notes in the Bank's possession.

The note sued upon having been paid, it is submitted that the court erred in allowing any recovery on this item.

T. P. Fisk Note

The T. P. Fisk note is in evidence as plaintiff's Exhibit 3 and has attached to it a contract entered into between Mr. Fisk and Mr. Stewart relative to a certain land deal known as "Shillapoo Lake Project," together with some other papers showing the accounts between the different parties interested in that project and particularly between Mr. Stewart and Mr. Fisk and a copy of a letter from Stewart to Fisk, dated January 24, 1921.

The evidence shows that Stewart, Fisk, Judge McKenney (Fisk's law partner and the Bank's attorney), Judge Miller (attorney for defendant in error), Mr. Wilkinson (Judge Miller's law partner) and a Mr. Crouch, druggist at Kelso, were associated as partners in a land reclamation project based on draining Shillapoo Lake, and that they all thought it a good, conservative project with bright prospects for a considerable profit. (R. 353-354). Stewart had agreed, conditionally, *to cause to be advanced* the moneys necessary to be paid by Fisk. He had actually advanced, for himself and Fisk, $12,500.00 and wished to transfer Fisk's obligation

to the Bank, and Fisk had agreed to sign the note. (See letter 1/24/21, Ex. 3, and Judge McKenney's testimony as witness for defendant in error. (R. 349, 350, 357).

It is clear that Stewart expected the note to be signed. Fisk is and was a reputable responsible citizen. The Fisk equity in the Shillapoo project, to which the Bank acquired an equitable lien, was then an asset, or at least was so considered by all of them. Stewart probably was too optimistic and too much of a plunger, as testified by Judge McKenney (R. 355-356) to be a safe banker and he should not have entered an unsigned note in the Bank, but it is hard to see any *bad faith or dishonesty* in Stewart's conduct. The Bank acquired an equitable lien in Fisk's share of the Shillapoo project and should have received Fisk's signature.

In its worst aspect, the taking of this credit into Stewart's account in the Bank can be construed to be no more than the giving of credit to Stewart (upon apparently ample security) without express authorization of the directors.

During the years from 1910 to the time the bank closed, the cashier, the assistant cashier, the directors, and other officers of the bank, repeatedly and without express authorization borrowed from the bank (R. 325-339; Exhibits 19-A and 20-A).

Prior loans to the cashier and other officers having been acquiesced in and ratified, the mere taking of the credit on account of the Fisk note cannot be construed as evidence of dishonesty.

Again, the whole transaction was in and upon the records of the Bank from January 19, 1921. It was known to the assistant cashier (the president's son-in-law and representative in the Bank) (R. 345) and the Bank never propounded any claim, notwithstanding the five days' notice requirement of the bond of May 1, 1920 (Pltf's. Ex. 2). Furthermore there is no evidence that the amount credited to Stewart's account was ever withdrawn, and, therefore no evidence of loss.

Kelso Farm Company Notes

The Kelso Farm Company had been a corporation in which Mr. Stewart was a stockholder. He had purchased the interests of the other stockholders, had disincorporated the corporation and was operating it under a trade name. (R. 348). The claim presented to the defendant (Ex. 16) shows that on January 12, 1921, a note executed by the Kelso Farm Company in the principal sum of $2200.00 was placed in the Bank and the entire amount credited to Mr. Stewart's account, and that, on February 15, 1921, another note of the Kelso Farm Company was placed in the Bank in the amount of $3750.00 and the entire proceeds deposited to the credit of Mr. Stewart. (R. 136).

It is admitted that the Kelso Farm Company was Stewart's farm and was merely a trade name under which he was operating and that this transaction was a loan credit by the Kelso State Bank direct to Mr. Stewart.

The minutes of the Kelso State Bank (Ex. 2-A)

show that, at a meeting of the directors of the Kelso State Bank held on January 11th, 1921, a loan in the sum of $6000.00 was authorized to Mr. Stewart, cashier of the Bank (R. 325-326). The $2200.00 note signed by the Kelso Farm Company was placed in the Bank the following day and the $3750.00 note later, making a total of $5950.00, or $50.00 less than the amount of the authorized loan.

There was no loan made to Stewart after the resolution of January 11, 1921, except the two loans above mentioned.

The notes were a part of the Bank's records from the respective dates on which they entered the Bank, and the assistant cashier had actual knowledge of them. (R. 325).

At the same meeting of the directors which authorized the loan to Stewart, January 11th, 1921, (Ex. 2-A) the entire board was appointed as an examining board, to meet monthly.

The transactions proven consisted only of credits to Stewart on the books of the Bank. There is no evidence that the Bank ever parted with anything, or that Stewart ever drew out the money credited to his account, and therefore no evidence of loss, and certainly authorized borrowings are not evidence of dishonesty.

Richter Estate Warrants

The court allowed recovery on account of four warrants amounting to Two Thousand and No/100 ($2000.00) Dollars, claimed to have been taken by

the cashier from the assets of the Phillip Richter Estate, of which he was administrator. This transaction occurred on October 23, 1920. No claim was made on account of this transaction, and the suit was commenced more than six months after the death of Stewart. All of the evidence went in over the objection of plaintiff in error, on the grounds that no claim had been made against the bonds on account of this transaction. The court permitted the testimony to go in, with the understanding that it would be ruled upon at the time of final disposition of the case. (R. 176). The evidence shows that the warrants were discounted by Stewart as administrator of the Richter Estate, and Stewart's account was credited with the amount of these warrants. (R. 179). The warrants were sold to the United States National Bank of Portland under a re-purchase agreement and were later returned by defendant in error to the Richter Estate (R. 180). There is no evidence that the Bank ever parted with the amount which was credited to the account of the cashier, or that he ever drew out any money after this transaction occurred.

The bond in force at the time the Richter Estate warrants were taken expressly provided:

> "3. In the event of the death of the Employe during the term of this bond, or of his suspension, dismissal, or retirement from the service of the Employer during the said term, this bond shall thereupon terminate without any action on the part of the Surety. The

right to make a claim hereunder shall cease at the end of six months after the termination, expiration, or cancellation of this bond.

"4. Upon the discovery by the Employer of any dishonest act on the part of the Employe the Employer shall at the earliest practicable moment, and at all events not later than five days after such discovery, give written notice thereof to the Surety at its home office. * * * Legal proceedings for recovery hereunder may not be brought until three months have elapsed after such proof of loss has been filed with the Surety."

It is admitted that the Bank closed on March 17, 1921, that the cashier disappeared or committed suicide on the same day; that no claim was made on account of the transactions in connection with the Richter Estate warrants or notice given to surety within six months after said 17th day of March, 1921.

This item was not included in the claim presented to the Surety by the defendant in error. (Ex. 16).

It is further admitted that no claim was presented to the Surety or notice given of loss on account of these transactions prior to the commencement of the action in the state court. The complaint in this action was served on October 30, 1921, and filed in the state court on December 14, 1921. (R. 15). Under the express provision of the bond above quoted, no recovery should have been allowed on account of the Richter Estate warrants.

Common Law Bonds

The trial court held that the bonds sued on are statutory bonds. The first bond was given several years before the statute was passed. Neither bond refers to the statute nor contains the provisions of the statute.

In the Indiana case of *U. S. F. & G. Co. v. Poetker*, L. R. A., 1917 B. 984, cited by defendant in error in the lower court, the bond contained all of the conditions of the statute and some additional provisions. The court held that the statutory provisions were exclusive.

The supreme court of Washington reached the opposite conclusion in the case of *Puget Sound State Bank v. Gallucci*, 82 Wash. 445; 144 Pac. 698; Ann. Cas. 1916A, 767.

The following from that decision is directly in point:

> "Counsel invoke the rules of strict construction applicable to lien statutes, insisting that such rules are applicable by analogy in favor of the surety company in this case. While the decisions do, in a measure, seem to recognize an analogy between lien laws and laws of this nature, and regard such laws as being, in a sense, in lieu of lien laws; yet we must remember that the right of the bank in this case does not rest alone upon the statute; *but that it rests primarily upon contract.* Indeed, the bank's right would be contractual even though there were nothing before us by which to meas-

> ure the surety company's obligation to the bank other than the language of the bonds, although that is the language of the statute. The bonds are no less contracts because they happen to be entered into in pursuance of the statute. *The obligation, therefore, resting upon the surety company is, in its last analysis, a contractual obligation voluntarily assumed by that company.*"

In the case of *Western C. & G. Ins. Co. v. Muskogee County* (Okla), 159 Pac. 655; L. R. A. 1917 B. 977, at page 983, the court said:

> "It is true, of course, that, if a bond omitted the statutory obligations, it could not be held to be a statutory bond. In such case, it would be a common-law bond, and would be measured, of course, by the terms of its obligations."

To the same effect, see the following cases:

9 Corpus Juris, 27;

U. S. v. Hodson, 10 Wall 395; 19 L. Ed. 937;

Stepheson v. Monmouth Min. & Mfg. Co., 84 Fed. 114;

Lowe v. City of Guthrie (Okla.), 44 Pac. 198, 200;

Smith v. Stubbs (Colo.), 63 Pac. 955, 956.

The bonds given in 1911 and 1913 were certainly not statutory bonds as the statute requiring bonds was not passed until 1917. No change was made or attempted to be made in the conditions of the bond given in 1913 and in force in 1917 to make it conform to the Statute. It was continued in force

thereafter in the same manner as before and it is clear that neither the plaintiff in error nor the Bank considered it a statutory bond or attempted to make it comply therewith.

The Statute reads as follows:

> "The board of directors of each banking and trust company shall require its active officers and employees and such other officers as they shall designate, each to give a surety bond, in such sum as the board shall specify and the state bank examiner shall approve, conditioned for the faithful and honest discharge of his duties and for the faithful application of all moneys, funds and valuables which shall come into his possession or under his control."
>
> Sec. 3239, Remington's Compiled Statutes of Wash. 1922; Laws of 1917, page 288, sec. 32.

An inspection of the bonds will show that none of them contain the conditions of the statute or similar conditions. Furthermore, the complaint in this action was not based upon a statutory bond, nor was the legal effect of the bonds pleaded, but the action was based upon the contracts contained in the bonds as written; nor were the bonds defective within the meaning of Sec. 777, Remington's Compiled Statutes, 1922. Said section reads as follows:

> "No bond required by law, and intended as such bond, shall be void for want of form or substance, recital, or condition; nor shall the

> principal or surety on such account be discharged, but all the parties thereto shall be held and bound to the full extent contemplated by the law requiring the same, to the amount specified in such bond. In all actions on such defective bond, the plaintiff may state its legal effect in the same manner as though it were a perfect bond. (L. '54, p. 219, Sec. 489, Cd. '81, Sec. 749; 2 H. C. Sec. 800)."

There is no contention that the bonds sued upon in the instant case were void for want of form or substance, recital or condition. Nor is there any contention that the bonds are in any manner defective within the meaning of the above statute. Furthermore, there was no attempt made by the defendant in error to plead, in its complaint, a statutory bond.

The bonds were given, and intended by the surety and by the Bank, as common law contractual obligations, and no thought of compliance with the statute entered into their execution.

Breach of Warranties

Before passing upon the application of the cashier for a bond, the American Bonding Company required the Kelso State Bank to furnish it an employer's statement answering certain questions relative to the cashier, his duties and employment and the supervision exercised over his work and acts.

Question number 11 reads as follows:

> "In case of applicant handling cash or se-

curities, how often will the same be examined and compared with the books, accounts and vouchers, and by whom?"

This question was answered as follows:

"The cash is examined every night. Securities all inventoried every week by some officer other than himself."

Said statement contained the following provision:

"It is agreed that the above answers shall be warranties and form a part of, and be conditions precedent to the issuance, continuance or any renewal of or substitution for, the bond that may be issued by the American Bonding Company of Baltimore, in favor of the undersigned, upon the person above named."

and was signed:

"KELSO STATE BANK, By F. M. Carothers, Vice-President."

A copy of said statement is attached to the answer as Exhibit "C," (R. 60-67), and the original is in evidence as part of Exhibit "38-A."

When the bond of plaintiff in error was substituted for that of the American Bonding Company in April, 1913, the Bank executed an employer's certificate, reading, in part, as follows:

"It is agreed that the information previously furnished by the undersigned to the American Bonding Company of Baltimore, Maryland, regarding the above named employe, his duties and employment and the supervision exercised

over the work and acts of the employe, shall be warranties and shall constitute the basis of and form part of the bond, or any continuation or continuations thereof, that may be issued by Fidelity & Deposit Company of Maryland to the undersigned in behalf of the employe whose application appears above."

This certificate was signed "Kelso State Bank, By F. M. Carothers, President."

A copy of said certificate is attached to the answer as Exhibit "D," and the original is in evidence as Exhibit "38-A."

The first bond provides:

"That the Employer, on becoming aware of any act which may be made the basis of any claim hereunder, shall immediately give the Company notice thereof, in writing, by a registered letter, addressed to the President of the Company, Baltimore, Maryland, and shall, within ninety days after its so becoming aware of such act as aforesaid, file with the Company its itemized claim hereunder at its own cost and expense, with full particulars thereto duly sworn to; * * * and this bond shall become void, both as to any existing, or future liabilities thereunder unless the aforesaid notice shall have been given as provided for, and unless claim is filed within the time and manner above specified, * * * Provided that no claim shall be payable hereunder that shall be filed with the Company after the period of

six months from the expiration or cancellation of this bond, or after a period of six months from the death, resignation or removal of the Employee, occurring prior to the expiration or cancellation of this bond. Provided Further, that there shall be no liability on this bond for any dishonest act or acts committed by the Employee after the Employers first becoming aware of any act which may be made the basis of a claim hereunder." (Exhibit No. 1.)

The second bond provides:

"Upon the discovery by the Employer of any dishonest act on the part of the Employee the Employer shall at the earliest practicable moment, and at all events not later than five days after such discovery, give written notice thereof to the Surety at its home office. Affirmative proof of loss under oath, together with full particulars of such loss, shall be filed with the Surety at its home office within three months after such discovery. Legal proceedings for recovery hereunder may not be brought until three months have elapsed after such proof of loss has been filed with the Surety, nor brought at all unless begun within six months after such proof of loss has been filed with the Surety. If any limitation set forth in this condition or in condition numbered 3 above is prohibited by the statutes of the state in which this bond is issued, the said limitation shall be deemed to be amended to agree with the

minimum period of limitation permitted by such statutes.

Upon the discovery by the Employer of any dishonest act on the part of the Employe this bond shall terminate, without any action on the part of the Surety, as to any act committed thereafter by such Employe." (Exhibit No. 2).

Each year, for the purpose of obtaining a renewal of the bond, the Kelso State Bank executed and delivered to the defendant a certificate as follows:

"This is to certify, that since the issuing of the above bond Mr. F. L. Stewart has faithfully, honestly and punctually accounted to me for all money and property in his control or custody as my employe, has always had proper securities and funds on hand to balance his accounts, and is not now in default to me.

KELSO STATE BANK,

By F. M. Carothers, President."

Copies of these annual renewal certificates are attached to the answer as Exhibits "E" to "K," inclusive, and the originals are in evidence as part of Exhibit "38-A."

The evidence shows that, for more than eleven years prior to the time the Bank closed, the cashier, as well as other officers, repeatedly and almost continuously borrowed money from the Bank upon promissory notes. These notes were carried in their proper places as part of the securities of the

Bank and were posted in the note register. A large number of these loans were made after the statute of 1917, prohibiting an officer of a bank from borrowing money from it without authority from the board of directors, became effective. (R. 325-337; Exs. "19-A" and "20-A").

If the Bank observed the warranty contained in the statement to the American Bonding Company relative to making inventory of securities weekly, it knew of these loans. If it did not do so, it breached said warranty, thereby releasing the bond.

If the notes of Stewart were not "proper securities," as certified by the Bank, the Bank was guilty of fraud and misrepresentations in procuring the renewals of the bond executed in 1913 and in procuring the new bond executed in 1920, which was executed in reliance upon a similar certificate dated April 26th, 1920. A copy of this certificate last mentioned is attached to the answer as Exhibit "K" and the original is in evidence as part of Exhibit "38-A."

The president of the Bank, who signed these certificates, must have known of the loans to Stewart and to the other officers, as a glance at the note register would have advised him of such fact. Furthermore, the note register was posted by his son-in-law, the assistant cashier.

If he did not know of the loans, the law will charge him with knowledge of the same, since such knowledge would have been obtained by a superficial examination of the securities or of the note

register, and it was his business to ascertain such facts as a slight examination would have revealed before making a positive statement that the securities were proper.

If these loans were not proper, the Bank knew of that fact many years before it was closed and, under the terms of the bonds, it was its duty to notify the surety at the earliest practicable moment, and at all events not later than five days after it became aware that the cashier was carrying securities which were not proper.

If the cashier "always had proper securities on hand to balance his accounts and was not in default to the Bank," as certified by the Bank, it was because the loans to him had been ratified. If they were not ratified, the certificates were false, and the cashier was in default to the Bank when the certificates were made, and the bond was released because notice of this default was not given as provided by the bond.

If the loans were ratified, there can be no recovery and, if they were not ratified, the warranties and representations contained in the application and in the certificates for renewal were breached or untrue, thus releasing the surety from liability.

Remington v. Fidelity & Deposit Co., 27 Wash. 429;

Kleeb v. Long-Bell Lumber Co., 27 Wash. 648;

Deer Trail, etc., Co. v. Maryland Casualty Co., 36 Wash. 46;

Trinity Parish v. Aetna Indemnity Co., 37 Wash. 514.

"It is made plainly to appear that there was enough to excite inquiry and to charge respondent with the duty of ascertaining the true state of the books, before making a statement that, on a certain date, they were found to be correct, and that cash and securities were on hand to balance them. It is the duty of an employer seeking indemnity insurance to use ordinary care to ascertain the truth of his statements before making them * * * and, while he is not to be charged with a knowledge which could only be discovered by an expert (*Remington v. Fidelity & Deposit Co.*, 27 Wash. 429), he is nevertheless charged with such knowledge as a cursory examination would have revealed."

Poultry Producers Union v. Williams, 58 Wash. 64 (69);

National Surety Co. v. Western Pacific Railway Co., 200 Fed. 675;

Johnson v. Franklin Insurance Co., 90 Wash. 631;

Goldstein v. National Fire Insurance Co., 106 Wash. 346.

"The failure of a bank, upon its officers being told that its teller was speculating, to notify at once the Guaranty Company which was on the teller's bond, of such information as it had, will defeat a recovery on such bond

for defalcations after the information was received by such officers where such bond provided that the bank should at once notify the company on its 'becoming aware' that the teller was engaged in speculation or gambling."

Guaranty Company of North America v. Mechanics Savings Bank & Trust Co., for the use of J. J. Pryor, assignee, 183 U. S. 402; 46 Law Ed. 253;

Carstairs v. American Bonding & Trust Co., 116 Fed. 449;

Hunt v. Fidelity & Casualty Co., 99 Fed. 242;

Young v. Pacific Surety Co. (Cal.), 70 Pac. 660;

Willoughby, as receiver of Capital National Bank v. Fidelity & Deposit Co. (Okla.), 85 Pac. 713; 7 L. R. A. (N. S.) 548;

Cherry, as receiver of Capital National Bank v. Fidelity & Deposit Co., 205 U. S. 537; 51 Law Ed. 920 (This affirms *Willoughby v. Fidelity & Deposit Co., supra*);

Dominion Trust Co. v. National Surety Co., 221 Fed. 618.

The president of the Bank had authority to make the representations and warranties made and they are binding on the Bank.

Willoughby v. Fidelity & Deposit Co. (Okla.), 85 Pac. 713; 7 L. R. A. (N. S.) 548; affirmed, 205 U. S. 537; 51 Law. Ed. 920.

The syllabus of the case last cited reads as follows:

"In an action upon a contract, the party seeking to recover cannot claim the benefits thereunder, and at the same time repudiate the burden. So in an action against a surety company to recover on the bond of a defaulting bank president, the bond must be construed as a whole, and the plaintiff's right to recover must depend upon such a construction; and where such bond is issued by a surety company and accepted by the bank, upon the faith of certain statements and representations in writing, made by the assistant cashier of the bank, relative to the conduct, duties, employment and accounts of the defaulting bank president, and such statements so made by the said assistant cashier are, by the terms of said bond, made a part of the bond itself, the bond and statement together form the contract, and they must be construed together and, upon their joint construction, or upon their construction as a whole, must depend the rights and liabilities of the parties thereto; and where the bond is issued by the surety company and accepted by the bank upon the faith of the statement and representations so made by the assistant cashier, the receiver of the bank, later appointed, in an action upon the bond, cannot be heard to repudiate or question the authority of the as-

sistant cashier to bind the bank by his statements and representations concerning the conduct, duties, employment and accounts of the defaulting bank president, and at the same time be allowed to recover upon the bond procured on the strength of the statements and representations so made by the said assistant cashier."

See also:

Warren Deposit Bank v. Fidelity & Deposit Co. (Ky.), 74 S. W. 1111;

Guaranty Company of N. A. v. Mechanics Savings Bank & Tr. Co., 183 U. S. 402; 46 Law Ed. 253.

If an employer makes a false answer, not knowing whether or not it is true, and without having used due diligence and precaution to learn the truth, such an answer is fraudulent and will defeat a recovery when relied upon by the insured.

Fidelity & Deposit Co. of Md. v. Kane (Ky.), 206 S. W. 888.

Non-observance of a promissory warranty vitiates the contract.

Elizey v. Mass. Bonding & Ins. Co. (La.), 77 So. 642;

Hunt v. Fidelity & Casualty Co., 99 Fed. 242;

Kentucky Vermillion M. & C. Co. v. Norwich Union Fire & Ins. Society, 146 Fed. 695 (C. C. A., 9 Circuit);

Bank of Cotton Valley v. McInnis, et al., (La.) 78 S. 727;

Bank of Hardinsburg & Trust Co. v. American Bonding Co. (Ky.), 156 S. W. 394.

In the two cases last above cited, the employer's statements were on forms identical with that furnished by the Kelso State Bank to the American Bonding Co. in the instant case.

In all of the above cases, the court held that failure to perform the promissory warranties contained in the employer's statements or in the conditions contained in the bonds or insurance policies would defeat recovery.

A reference to Exhibit 19-A will show that the cashier of the Kelso State Bank borrowed money from the Bank during each of the years 1910 to 1921 inclusive.

From 1917 it was a felony for an officer of a Bank to borrow money from the Bank without having previously obtained an authorization of the board of directors, yet Mr. Stewart borrowed money from the Bank on two notes, amounting to $1100.00. In 1918 he borrowed money from the Bank on three notes, amounting to $2300.00. In 1919 he borrowed money from the Bank on seven notes, amounting to $11,209.94, and in 1920 he borrowed money from the Bank in the total amount of $14,000.00. No claim has been made on account of any of these loans, as they were all repaid. There is nothing in the minutes showing any authorization by the board of directors for any of these loans, and the testimony is that there was no authorization for the loans.

These loans were regularly posted in the books of the Bank, the notes were carried in the proper place, and any superficial examination of the Bank's books, records or notes would have disclosed them. If the Bank performed the conditions of the promissory warranties relative to the examination of securities every week by some officer other than the cashier, it knew of these loans. If it did not perform these conditions, it breached the warranties and there can be no recovery. It was the duty of the president of the Bank to make a superficial examination, at least, of the securities and funds, before making the certificates for the purpose of securing annual renewals of the bonds. If he did not make this examination, he was guilty of fraud in certifying something as a fact which he did not know to be a fact. If he did make the examination, he was guilty of fraud in certifying that the cashier had always had proper securities on hand when he knew that the cashier had been carrying his personal notes in the Bank contrary to law.

Hunt v. Fidelity & Casualty Co., 99 Fed. 242, and cases above cited.

As stated by this court, in the case of *Kentucky Vermillion M. & C. Co. v. Norwich Union Fire Ins. Society*, 146 Fed. 695, on page 702:

> "The provision in question was made a warranty, and the burden of proof in regard thereto rested upon the plaintiff in error to prove a compliance upon its part with this provision."

There can be no recovery therefore, because of the warranties breached.

Ratification

Defendant in error's argument in the lower court was based upon the theory that Mr. Stewart was borrowing, either directly or indirectly, from the Bank in violation of the statute prohibiting an officer from borrowing money without having first obtained the consent of the board of directors. The only direct loan to him, upon which any claim is made, was the Kelso Farm Company loans, which were expressly authorized. In all of the other cases the loans were made on notes signed by persons with whose credit the Bank apparently was satisfied.

The records of the Bank show that Mr. Stewart had been borrowing money from the Bank continuously from at least as early as 1910; that practically all of the directors of the Bank had been borrowing money at various times, and that the assistant cashier of the Bank had been borrowing money from the Bank a great number of years. (R. 325-337; Ex. 19-A and 20-A). The first and only written authorization of any loan to Stewart was that of January 11, 1921 (Ex. 2-A), and there is no authorization of any loan to the other directors. (R. 325-339; Ex. 2-A).

It is admitted that there was no attempt made by Mr. Stewart at any time to conceal the transactions sued upon in this case, or any other transactions in connection with his management of the

Bank. (R. 236). The notes given by himself to the Bank, during all of these years since 1910, including those sued upon in this case, were always in their proper place among the records of the Bank, and the note register contained a complete history of the various loans which Mr. Stewart, and the other directors and officers, had procured from the Bank over a period of years.

What the officers or directors knew, or by an ordinary examination might have ascertained, is presumed to be within the knowledge of the Bank. All of Stewart's transactions were matters of record on the books of the Bank. When notes were received, the items charged in the complaint were credited on the books to his account. The Bank has sat by, since each of the several transactions, with this knowledge or presumed knowledge, and thereby ratified the transaction, taking the benefit by way of interest and principal payments and collateral security, and renewals, and is now estopped to question the transactions.

> "While the acts of an officer may, of course, be ratified by resolution of the board of directors, it is not necessary for the board to act as a board in order to effect ratification, or that the ratification should be shown by the records of the bank. Ratification may be inferred from conduct, such as accepting the benefits resulting from an officer's act, or bringing suit on a note taken or contract made by an officer, or even from mere silence, when the acts are

known, and especially when they are repeated and no dissent within a reasonable time is shown."

7 C. J. 538.

"A bank may be estopped to deny the authority of an officer to do certain acts, where it has accepted the benefits of such act * * *, or where the directors have acquiesced in a particular course of conduct of which the acts are a part."

7 C. J. 539.

In the case of *First National Bank of Pullman v. Gaddis*, a Washington decision, the cashier and assistant cashier of the bank had loaned money to a speculative corporation in which both of them were stockholders and the assistant cashier was treasurer. The action was against them individually to recover the amount which had been lost by loans to their corporation. The court held that the loans had been ratified and that there was no liability on the part of the defendants. In the opinion, the court said:

"Even if the Kootenai County Mining & Milling Co. was a speculative corporation and was not entitled to credit in the first instance, and the cashier and assistant cashier of the bank knew that fact, even if they were not authorized to extend credit to the said mining company in the beginning, yet when the directors of the bank knew that credit had been extended and made no objection thereto, the

bank cannot, after five years' dealing with that company, hold the cashier or assistant cashier for the amount which the company may owe the bank at the end of that time. After a course of dealing for such a length of time, where the directors of the bank knew about it, the bank will be held to have ratified the credit."

First National Bank of Pullman v. Gaddis, 31 Wash. 596 (600); 72 Pac. Rep. 460; *Monogahela Coal Co. v. Fidelity & Deposit Co.*, 94 Fed. Rep. 732 (737).

In the case of *Roberts v. Washington National Bank*, 11 Wash. 550. 40 Pac. Rep. 225, the receiver of the Washington Savings Bank attempted to recover from the Washington National Bank certain property, or the value thereof, which it was claimed had been fraudulently obtained by the Washington National Bank from the Washington Savings Bank. It appeared that the cashier of the Washington National Bank was the treasurer of the Washington Savings Bank and that, in the transactions, he had acted as agent for both banks. The court held that both of the banks had either expressly, or impliedly ratified his agency and authorized him to transact business in the manner in which it was transacted as agent for both banks.

On page 558 of the opinion, the court states:

"It also abundantly appears therefrom that the transactions between the banks, almost from the day of the organization of the national one, were such as would have been justi-

fied only by such an understanding or agreement. That such was the course of dealing is not very strongly disputed by the respondent, but it is claimed by him that the boards of directors of each of the banks were not shown to have had any knowledge of this course of dealing. It appeared from the practically undisputed proofs that this course of dealing had been continued for two years; that its existence during all of this time would have been shown by an examination of the books of either of the banks, and especially by an examination of those of the savings bank. This being so, we think it must be presumed that the board of directors had knowledge thereof. That even a superficial examination of the books of the savings bank would have shown these transactions, is evident from the proofs, and that it was the duty of the board of directors to make at least a superficial examination many times during this period of two years is a fact of which the court will take judicial notice, and if they did not make it, they or those whom they represent must stand the consequences, and not those with whom the corporation may have had dealings."

In the lower court, defendant in error cited certain cases to the effect that the directors could not ratify the loans made by Stewart, or to Stewart. The cases cited are not in point for the reason that the acts attempted to be ratified in those cases were

acts which were inherently dishonest and could not have been authorized before they were done. The loans to Stewart or to others were all acts which could be authorized by the directors and were, therefore, capable of ratification.

First National Bank of Pullman v. Gaddis, 31 Wash. 596;

3 R. C. L. 455, and cases cited.

A surety company is not liable, under a bond indemnifying a bank against loss from embezzlement by its cashier, for loss resulting from acts authorized, ratified or confirmed by the board of directors, though such transactions were *ultra vires* and beyond the scope of the directors' power to authorize and ratify.

Citizens' Guaranty State Bank of Hutchins v. National Surety Co. (Texas), 242 S. W. 488.

Every transaction complained of was ratified, either expressly or by acquiescence, and there can be no recovery.

No Dishonesty

The bonds sued on cover pecuniary loss sustained by reason of any dishonest acts committed by the Cashier.

Whether the transactions complained of constitute "dishonest acts" depends upon the intention of Mr. Stewart at the time—in other words, his state of mind.

Honesty means sincerity and good faith. One may be honest, although mistaken.

Webster's Dictionary.

For instance, to take human life, honestly although mistakenly believing that it is necessary in self-defense, is not murder.

State v. Churchill, 52 Wash. 210; 100 Pac. Rep. 309.

Robinson v. Territory, 85 Pac. (Okla.) 451.

Transactions on the part of Stewart, although involving poor business judgment on his part, are not dishonest unless in the exercise of bad faith.

Clark v. Fidelity & Deposit Co., 73 Wash. 62; 131 Pac. 468.

That Stewart became indebted to the Bank through the giving of notes or the taking of credits from notes of others is no evidence of dishonesty.

Monongahela Coal Co. v. Fidelity & Deposit Co., 94 Fed. 732.

Simple mistake, made without fraud, is not evidence of dishonesty.

Kansas Flour Mills Co. v. American Surety Co., 158 Pac. 1118.

Loans to companies in which Mr. Stewart may have been interested do not constitute a wrongful taking or a conversion.

First National Bank v. Gaddis, 31 Wash. 596 (600); 72 Pac. 460.

Fisher v. Murdock, 13 Hun. (N. Y.) 485.

The evidence conclusively shows that, whatever Mr. Stewart's faults may have been, he was not

endeavoring to cause loss to the Bank. On the contrary, he was making personal financial sacrifices to make good bad paper which it held.

For instance, in his dealings with Frank Shepard, he gave the Bank $14,000.00 of notes which belonged to him personally, in order to retire worthless paper of the Cowlitz Bridge Co. and the Independent Navigation Co. (Ex. "16").

Again, he personally guaranteed all loans to the Bank to the extent of $50,000.00. (Ex. "2-A").

In all of the transactions where he took credit in his account, the money was actually due to him from the maker of the note and the application to his account was satisfactory to the maker.

No transaction was covered by the veil of secrecy. Mr. Adams testified, as the books show, that his entries were open and frank and easily followed. (R. 235-236).

Apparently the only evidence of dishonesty is the claimed uncollectibility of the paper itself. All of the claims sued on, as testified by Mr. Adams, were based upon a mere finding upon his part that Stewart had taken credit from loans made by the Bank and such loans had not been paid. (R. 216-218). Such is not the test of dishonesty.

An agent of several insurance companies who deposits collections of the different companies in the bank to his individual account, and checks on it to meet the needs of the business, without any objection by the companies, is not guilty of embezzlement for failing to account for premiums col-

lected and deposited in the bank within a bond given to indemnify one of the insurance companies against such appropriations of money by the agent as amounted to larceny or embezzlement.

The court said:

> "He drew on the general fund composing his deposit account for the conduct of his business as a general agent for all the companies. He could not be justly charged with *conscious* wrongdoing, when his principals, by their silent acquiescence in this course of business, gave their sanction to the hazard which it entailed. In this view, the corrupt motive *necessary* to make out a case of embezzlement did not exist."
>
> *Dixie Fire Ins. Co. v. Nelson*, 128 Tenn. 70; 157 S. W. 416.

The record is devoid of evidence of any action by Stewart designed or intended to cause the Bank to sustain loss. The liability of plaintiff in error is for his fraud or dishonesty. Bad loans do not constitute dishonesty, and there can be no recovery.

No Loss

Defendant in error has proved no loss sustained.

To warrant a recovery, it was his burden to claim, under the terms of the bonds, and prove a loss—that is, that it parted with moneys through the fraudulent or dishonest conduct of the cashier.

The evidence in this case is confined to the passing of credits to the cashier's ledger account. There is no evidence whatever that these moneys were

ever disbursed, much less is there any evidence that they were disbursed dishonestly or fraudulently, or even for the cashier's personal benefit.

If the bank sustained loss, such loss was sustained when it parted with something of value, that is, money, and, therefore, it should have propounded its claim for such disbursements, as of their several dates and amounts, and, at the trial, have proved these disbursements, and that they constituted a loss to the bank, and that such loss was not authorized or ratified by the bank through its officers or directors.

No such evidence was offered and there can be no recovery.

It is elementary that the basis for recovery on any contract of insurance is a loss to the insured. A loss necessarily implies a deprivation or a damage.

Geo. Birrell, Inc. v. Fidelity & Casualty Co. (Iowa), 188 N. W. 26, 29.

Bookkeeping credits do not constitute a loss. The loss occurs when the bank parts with something of value. Manifestly the bank parted with nothing when it passed a credit to the cashier's account. It could have rescinded the credit at any time thereafter until the money had been disbursed, if it ever was, by charging his account with a like amount.

State v. Larson, 119 Wash. 259; 205 Pac. 373.

In the Iowa case above cited, the president of a corporation applied the assets of the corporation

to the payment of certain debts of the corporation, which he himself had agreed to pay. The Court held that the application of these assets did not constitute a loss within the meaning of the bond, because the corporation was liable to pay the debts.

The facts in that case are particularly applicable to the facts in the instant case relative to the Frank Shepard notes, except that, in the present case, there is no evidence that the bank ever parted with the money which was credited to the cashier's account in reimbursement of the moneys which he used in paying the obligation of the Kelso State Bank to the United States National Bank.

In the *Larson* case, Mr. Larson, contrary to law, created an overdraft while acting as president of the bank. Thereafter he satisfied the overdraft on his ledger account by giving his note to the bank. The court held that the loss occurred when the overdraft was created by paying checks against his account. There is no difference, in principle, whether the checks are drawn prior or subsequent to the time the credit is entered on the officer's ledger account. The loss occurs when the bank parts with its money, and as to this there is neither claim, pleading nor proof in the present case.

Suppose, for illustration, defendant in error had produced checks against Mr. Stewart's account, showing that all of the credits passed to his account had been disbursed, and suppose further that an

examination of these checks showed that his disbursements were entirely in payment of obligations which the bank itself owed. It is obvious, and within the authority of the Iowa case above cited, that the bank, in such event, sustained no loss, and there could be no recovery. Much less can there properly be a recovery when there is not even proof that the money has been disbursed for any purpose.

Plaintiff in error was entitled, under the terms of its bond, to notice of the disbursements through which it was claimed Mr. Stewart has caused the bank to sustain loss, and to opportunity to investigate the matter of those disbursements prior to the time of trial, so that it might establish, if the facts warranted, that the items were not such as to constitute loss to the bank. The disbursements, if any, made by Mr. Stewart out of his account, for and on account of obligations of the bank, did not constitute loss. Plaintiff in error is entitled to the protection which such a claim and opportunity of proof would afford, and defendant in error cannot avoid this by merely showing proof of credits and avoiding the issue as to the disbursements and their nature.

Variance

In the case of three of Phillips' notes, all of the Frank Shepard notes, and one of the Northwest Transportation Company notes, the Court, over objection of the plaintiff in error, permitted the defendant in error to introduce testimony tending

to show entirely different transactions than those alleged in the complaint.

The complaint alleged that by reason of dishonest and fraudulent acts of the cashier the bank suffered a pecuniary loss of money on account of said cashier's wrongfully apropriating to his personal or individual account, through the giving and renewal of notes of H. D. Phillips, said notes being dated as follows: Two notes in the amount of $1500.00 each, dated March 20, 1918, and one note in the amount of $550, dated the same date (R. 9-10). The evidence showed that, when the two notes in the amount of $1500 each entered the bank, the proceeds were credited to a cash item which originated on March 11th, and that this cash item had been used in some manner in connection with an estate of Henry Dearing, an incompetent (R. 156-157). There was no evidence that the proceeds of these two notes was deposited to the account of the cashier, and the evidence relative to the Henry Dearing estate was not within the issues of the case.

The plaintiff in error had not been advised of any claim on account of any transaction in connection with this estate, either by notice, claim or pleading, and did not have any opportunity to investigate concerning the same.

In the claim filed and in the complaint, it was claimed that Stewart had appropriated to his own use the $550, the proceeds of the $550 note of

March 20, 1918 (R. 9-10, Ex. 16). The evidence showed that, when this $550 note entered the bank, only $50 was deposited to the account of the cashier, and the other $500 was deposited to the account of a man by the name of N. E. Que (erroneously copied in the transcript as N. E. Q.) (R. 157-158).

The plaintiff in error was not advised, prior to the time this evidence was given, by notice, claim or pleading that the defendant in error claimed any of the proceeds of this note had any connection with the account of N. E. Que, and was given no opportunity to investigate or meet this evidence.

In the claim filed and in the complaint, it was alleged that Stewart had misappropriated the proceeds of the four Shepard notes dated April 23, 1920, July 19, 1920, and two notes dated August 13, 1920, in the amount of $1000 each (Ex. 16, R. 11). The evidence showed that the cashier did not receive any benefit from these notes, but that the proceeds were deposited to his account to reimburse him for moneys which he had, immediately prior thereto, advanced to pay obligations of the Kelso State Bank to the United States National Bank (R. 393-365). The testimony further showed that, when the original notes entered the bank, the cashier did not receive anything, but that these notes, together with the proceeds of those discounted with the United States National Bank, were used to retire notes of the Independent Navigation Company in the Kelso State Bank. These

notes of the Independent Navigation Company had been in the bank for as much as two and three years prior to the time the Shepard notes entered the bank (R. 394-396). Over the objection of plaintiff in error, the court allowed evidence tending to show that the original Independent Navigation Company notes, which had entered the bank in 1917 and 1918, were executed by a company controlled by Mr. Stewart. If the bank lost anything, it was when these notes of the Independent Navigation Company entered the bank, some two or three years prior to the time alleged in the complaint and in the claim filed. Of this claim of loss, plaintiff in error was not advised by notice, claim or pleading, and was given no opportunity to investigate or determine whether there had been any loss when the Independent Navigation Company notes entered the bank, or whether they had been given to retire worthless paper held by the bank.

In the claim and in the complaint, it was alleged that Mr. Stewart appropriated $450 out of the proceeds of a $2000 note of the Northwest Transportation Company, dated March 10, 1921 (R. 12; Ex. 16). Over objection of the plaintiff in error, the Court allowed evidence that this $450 was deposited to the account of the cashier out of the proceeds of a $1250 note of the Northwest Transportation Company (R. 171-174). Of this transaction plaintiff in error was not advised by notice, claim or pleading.

A party cannot allege one state of facts in his

complaint and recover judgment by proof of an entire different state of facts at the trial.

Distler v. Dabney, 3 Wash. 200; 28 Pac. 335;

Clark v. Sherman, 5 Wash. 681; 32 Pac. 771;

Jacobs v. First Nat. Bank, 15 Wash. 358; 46 Pac. 396;

22 Enc. of Pl. & Pr. 527.

In the case of *Jacobs v. First Nat. Bank*, *supra*, the Court said

> "It is elementary that a party must prevail according to the case made by his pleading or not at all."

In 22 Enc. of Pl. & Pr. at page 527, the rule is stated as follows:

> "It is a general rule in actions at law that, in order to enable the plaintiff to recover or the defendant to succeed in his defense, what is proved, or that of which proof is offered by the party on whom lies the *onus probandi* must not vary from what he has previously alleged in his pleading; and this is not a mere arbitrary rule, but is one founded on good sense as well as good law."

It is respectfully submitted that the Court erred in permitting the evidence relative to transactions not pleaded and that there was an utter failure of proof of the transactions pleaded in regard to the foregoing items.

CONCLUSION.

We respectfully submit:

I.

That, since plaintiff in error has paid, as surety, an obligation of the Kelso State Bank, as principal, in excess of the penalty of the bond sued on herein, there can be no recovery against it, in any event, and that therefore the cause should be reversed and ordered dismissed.

II.

That, aside from the claim of set off, there can be no recovery from plaintiff in error because:

(a) The obligation sued on was executed and continued in consideration of certain representations and warranties hereinabove discussed which were either untrue or breached to the prejudice of plaintiff in error, with the result that no liability exists in law upon such obligation;

(b) Each and all of the transactions complained of as causing loss to the Bank were open and aboveboard and of record in the Bank, and either known, or conclusively presumed in law to be known, to the Bank, and have therefore been ratified and affirmed by the Bank;

(c) No dishonesty has been shown in the transactions complained of, but only bad judgment in making loans to others than the cashier, and, the obligation sued on covering only, substantially, dishonest acts, no liability in law rests upon plaintiff in error for the losses so sustained;

(d) The defendant in error neither claimed,

alleged nor proved any items of loss to the Bank, but was content to claim for bookkeeping *credits only*, whereas losses would appear on the books as charges or *debits* for disbursements. In other words, defendant in error claimed, alleged and proved the credits appearing on Stewart's account in the Bank, instead of the disbursements by check, if any, which represented the outflow of the Bank's assets as a loss.

III.

That the trial court, over timely objection of plaintiff in error, permitted evidence of transactions (claimed by defendant in error to have caused the Bank to sustain loss), of which plaintiff in error had no prior information, either by way of claim or pleading, and that such evidence was a variance and such items were improperly allowed, whatever the event of the other aspects of this case; and that therefore the judgment must be reversed, or at least modified.

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